



Report of Independent Auditors and Financial
Statements with Required Supplementary
Information and Other Information for

King County Water Quality
Enterprise Fund (An Enterprise
Fund of King County, Washington)

December 31, 2014 and 2013

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Metropolitan King County Council
Seattle, Washington

Report on Financial Statements

We have audited the accompanying financial statements of the King County Water Quality Enterprise Fund (Water Quality), which comprise the statements of net position as of December 31, 2014 and 2013, and the related statements of revenues, expenses, and changes in net position, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the King County Water Quality Enterprise Fund as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 11 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on Water Quality's financial statements. The Supplemental Schedule of Net Revenues Available for Debt Service is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The supplemental schedule has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Moss Adams LLP

Seattle, Washington

May 13, 2015

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

The management of King County Water Quality Enterprise Fund (Water Quality) presents to readers of its financial statements this narrative overview and analysis of its activities and financial performance for the fiscal years ended December 31, 2014 and 2013.

THE SEWER SYSTEM

Water Quality provides regional wastewater treatment services to Western Washington in King County, part of Snohomish County, and part of Pierce County with a service area encompassing over 415 square miles. The major wastewater treatment facilities include three secondary treatment plants at West Point in Seattle, South Plant in Renton and the Brightwater Treatment Plant located near Woodinville and two smaller secondary treatment plants at Vashon Island and Carnation, 391 miles of interceptors, 47 pump stations, and 25 regulator stations. Other facilities include four combined sewer overflow treatment plants (CSO) and 38 CSO control locations. The sewer system collected and treated an average of 186 million gallons per day in 2014 from approximately 1.5 million residents.

FINANCIAL HIGHLIGHTS

During 2014, Water Quality provided sewage treatment services to 725,844 residential customer equivalents (RCE) compared to 718,160 in 2013 and 708,900 in 2012. An RCE is one single-family residence or an equivalent unit of 750 cubic feet of monthly water consumption for all other customers such as multifamily residential, commercial, and industrial properties. The capacity charge program added 10,767 new connections to its customer billing base in 2014. The program added 7,224 and 7,915 new connections in 2013 and 2012, respectively. In 2014, the average flow of the five treatment plants was 186 million gallons per day (MGD) with a peak daily flow of 541 MGD. Maximum system capacity remained at 895 MGD in 2014 and 2013. The average daily flow fluctuated between a low of 167 MGD in 2013 and a peak of 186 MGD in 2014. The annual fluctuation in flows largely depends on the amount of annual precipitation.

In 2014, Resource Recovery delivered 119,325 tons compared to 115,801 tons in 2013 of Loop® biosolids to customers for use in forest management, agriculture, and composting. Approximately 75 million gallons compared to 65 million gallons in 2013 of Class A reclaimed water was distributed for irrigation, urinals/toilets, municipal purposes, and wetland enhancement and about 700 million gallons of filtered, treated wastewater were used for internal treatment plant processes. The reclaimed water permitted capacity at South Plant is 1.2 MGD and the Brightwater reclaimed water distribution capacity is 21 MGD. Water Quality sold 1.9 million therms of natural gas to Puget Sound Energy from the South Treatment Plant, and produced 16.9 million kilowatt hours of electricity from digester gas at the West Point Treatment Plant, which was sold to Seattle City Light. In 2013, Water Quality sold 1.5 million therms of natural gas to Puget Sound Energy and 6.5 million kilowatt hours of electricity produced from digester gas. Increased electricity production from digester gas resulted from the 2014 completion of the Waste-to-Energy project at West Point Treatment Plant.

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

The Industrial Pretreatment Program conducted 347 inspections and took 1,700 compliance samples in 2014 compared to 363 inspections and 1,610 compliance samples taken in 2013. The program currently tracks 514 facilities with discharge authorization permits and 121 significant industrial users.

Water Quality currently has 38 combined sewer overflow facilities plus 4 CSO treatment facilities. An aggressive effort conducted in concert with the City of Seattle has resulted in a significant reduction in combined sewer overflows from a baseline of 2.3 billion gallons per year in years 1980-1983 to an average of 800 million gallons per year. Currently there are six projects underway of the 14 remaining projects from the Regional Wastewater Services Plan (RWSP).

In 2012, the Environmental Protection Agency (EPA) entered into a consent decree with Water Quality to reduce CSO overflows by 2030 based on Water Quality's 2012 Amended Long-term CSO Control Plan outlining the remaining CSO projects. The consent decree includes an option to develop an integrated plan which may result in lower costs to complete the CSO program. The EPA and Washington Department of Ecology will monitor Water Quality's progress with CSO control and work closely with the enterprise going forward to achieve acceptable CSO levels.

In 1999, the Metropolitan King County Council adopted the RWSP to construct additional capacity, protect public health and provide for future projected population growth in its service area through 2030. Major RWSP projects include the building of the Brightwater Treatment Plant, improvements to the regional Conveyance system, construction of 21 CSO control projects, and expansion of the South Treatment Plant to 135 million gallons per day capacity by 2029. The RWSP also includes projects to control infiltration and inflow into the Conveyance system, process additional biosolids, and produce additional reclaimed water. Total capital program expenditures were \$155.4 million in 2014 and \$163.5 million in 2013.

Water Quality operating revenues increased by 3.3 percent to \$435.8 million in 2014 from \$422 million in 2013 while operating expenses before depreciation and amortization increased by 6.1 percent to \$124.2 million in 2014 from \$117.1 million in 2013.

The monthly sewer rate stayed the same at \$39.79 per RCE in 2014. In 2013, it increased from \$36.10 to \$39.79. The capacity charge rate increased to \$55.35 per RCE in 2014 from \$53.50 in 2013. Capacity charge revenues increased 1.4 percent to \$59.6 million in 2014 from \$58.8 million in 2013. The RCE's billed for sewer treatment services increased to 725,844 in 2014 from 718,160 in 2013. The rate stabilization reserve decreased to \$34.3 million in 2014 from \$52.3 million in 2013. This decrease of \$18 million in the reserve balance increases operating revenues for the year and has been included in the calculation of debt service coverage for 2014. Future deposits to the rate stabilization reserve will decrease operating revenues and debt service coverage in the year of the deposit. Withdrawals will have the opposite effect of increasing operating revenues and debt service coverage in the year the rate stabilization reserve is reduced.

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

The rate stabilization reserve, as mandated by the Metropolitan King County Council as part of its rate setting activities, requires Water Quality to set aside a portion of current revenue for future periods in order to moderate the impact of rate increases over time.

Water Quality issued \$267.5 million in Sewer Revenue and Refunding Bonds in 2014, including \$5.3 million for new construction. This resulted in \$32.0 million in savings over the lives of the refunded issues or \$21.6 million in present value of debt service savings. This compares to \$197.8 million of Sewer Revenue and Refunding Bonds issued in 2013, including \$50.0 million for new construction and \$3.0 million in additional bond reserves. Additionally in 2014, \$22.3 million in low interest state loans were received at rates between 0.5 percent and 2.82 percent compared to \$19.6 million received in 2013.

The results of operations for 2014 and 2013 produced a debt service coverage ratio on senior lien debt of 1.44 and 1.42, respectively, exceeding the coverage covenant requirement of 1.15 in both years. The total debt coverage ratio of 1.33 in 2014 and in 2013 exceeded the 1.15 policy minimum in both years.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is intended to serve as an introduction to Water Quality's basic financial statements. The basic financial statements are comprised of the comparative statements of net position; statements of revenues, expenses and changes in net position; statements of cash flows; and the notes to the financial statements, which explain certain elements of the financial statements in greater detail.

REQUIRED FINANCIAL STATEMENTS

Water Quality's financial statements provide information with respect to all of its activities using accounting methods similar to those used by private-sector companies. The statements provide both long-term and short-term information about Water Quality's financial status.

The comparative statement of net position presents information on all of Water Quality's assets, liabilities and deferred inflows/outflows of resources, with the difference presented as net position as of each year-end. Over time, the statements demonstrate Water Quality's financial health by providing a basis for the reader to evaluate capital structure, liquidity, and financial flexibility.

The two most recent years' operating and non-operating revenues and expenses of Water Quality are accounted for in the statements of revenues, expenses and changes in net position. The statements illustrate the current and prior period results of operations and recovery of costs by receipt of fees, and are instrumental in demonstrating Water Quality's continued creditworthiness. All changes in net position are reported as soon as the underlying event occurs, irrespective of the timing of related cash flows. The receipt of monthly sewage treatment charges provides the principal support for Water Quality's activities. Sewage treatment charges of \$364.6 million (including the rate stabilization transfer) provided 83.7 percent of operating revenues in 2014 and \$353.3 million provided 83.7 percent of operating revenues in 2013. Water Quality is a wholesale provider of sewage treatment services to 34 municipal and 3 non-municipal participants in King, Pierce, and Snohomish counties. The receipt of the monthly payments is governed by service agreements, the majority of which expire in July 2036.

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

The statements of cash flows report cash receipts, cash payments, and net changes in cash derived from operations, financing, and investment activities. From the statements, the reader can discern Water Quality's sources and applications of cash during 2014 and 2013, reasons for differences between operating cash flows and operating income, and the effect on the statements of net position from investing, capital, and financing activities.

The notes to financial statements provide additional information essential to obtain a full understanding of the data provided in the basic statements.

In the following comparative analysis of the financial statements, percentages and ratios were calculated and rounded using the actual detail from the financial statements.

FINANCIAL ANALYSIS OF THE STATEMENTS OF NET POSITION

Comparative data, stated in millions of dollars:

| | Years Ended December 31, | | |
|---|--------------------------|----------|----------|
| | 2014 | 2013 | 2012 |
| Current assets | \$ 407.5 | \$ 457.9 | \$ 304.8 |
| Noncurrent assets | 216.8 | 236.0 | 249.7 |
| Capital assets | 4,122.9 | 4,128.4 | 4,141.2 |
| Other | 97.8 | 95.9 | 82.3 |
| Total assets | 4,845.0 | 4,918.2 | 4,778.0 |
| Deferred outflows of resources | 101.9 | 92.0 | 94.4 |
| Total assets and deferred outflows of resources | 4,946.9 | 5,010.2 | 4,872.4 |
| Current liabilities | 434.8 | 435.6 | 295.9 |
| Long term liabilities | 3,922.7 | 3,962.4 | 3,952.8 |
| Total liabilities | 4,357.5 | 4,398.0 | 4,248.7 |
| Deferred inflows of resources | 34.3 | 52.3 | 62.6 |
| Total liabilities and deferred inflows of resources | 4,391.8 | 4,450.3 | 4,311.3 |
| Net position-net investment in capital assets | 210.4 | 206.9 | 200.1 |
| Net position-restricted | 205.3 | 203.3 | 254.8 |
| Net position-unrestricted | 139.4 | 149.7 | 106.2 |
| Total net position | \$ 555.1 | \$ 559.9 | \$ 561.1 |

Net position serves as a useful indicator of Water Quality's financial position. As of December 31, 2014 and 2013, assets and deferred outflows of resources exceeded liabilities and deferred inflows of resources by \$555.1 million and \$559.9 million, respectively.

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

Of the total Water Quality assets and deferred outflows of resources, 83.3 percent or \$4,122.9 million were invested in capital assets such as treatment plants, pumping and regulator stations, interceptors, and other equipment at year-end 2014. For the year-end 2013, 82.4 percent or \$4,128.4 million were invested in capital assets. Water Quality uses its capital assets to provide wholesale wastewater collection and treatment services in King, Pierce, and Snohomish counties. Current operating and debt service requirements are met by operating and non-operating revenues composed of monthly sewage treatment charges, a capacity charge for new customers, other special-handling charges, miscellaneous operating revenues, and investment earnings.

The net position decreased by 0.9 percent or \$4.8 million in 2014 to \$555.1 million from \$559.9 million in 2013. Restricted net position increased by 1.0 percent or \$2.0 million in 2014 to \$205.3 million from \$203.3 million in 2013. The unrestricted net position decreased by \$10.3 million in 2014 to \$139.4 million from \$149.7 million in 2013.

The net position decreased by 0.2 percent or \$1.2 million in 2013 from \$561.1 million in 2012. The restricted net position decreased by \$51.5 million in 2013 from \$254.8 million in 2012. The unrestricted net position increased by \$43.5 million in 2013 from \$106.2 million in 2012.

FINANCIAL ANALYSIS OF THE STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET POSITION

Comparative data, stated in millions of dollars:

| | Years Ended December 31, | | |
|--------------------------------|--------------------------|----------|----------|
| | 2014 | 2013 | 2012 |
| Sewage treatment fees | \$ 346.6 | \$ 343.0 | \$ 307.2 |
| Rate stabilization | 18.0 | 10.3 | 13.9 |
| Capacity charge revenue | 59.4 | 58.8 | 51.4 |
| Other revenue | 11.8 | 9.9 | 9.4 |
| Operating revenues | 435.8 | 422.0 | 381.9 |
| Operating expenses | 290.8 | 278.2 | 252.4 |
| Operating income | 145.0 | 143.8 | 129.5 |
| Non operating (expenses) | (149.8) | (145.3) | (136.3) |
| Grant revenues | - | 0.3 | - |
| Change in net position | (4.8) | (1.2) | (6.8) |
| Net position beginning of year | 559.9 | 561.1 | 567.9 |
| Net position end of year | \$ 555.1 | \$ 559.9 | \$ 561.1 |

While the statements of net position show changes in assets, liabilities, deferred inflows/outflows of resources and net position, the statements of revenues, expenses and changes in net position provide insight into the source of these changes.

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

During 2014, operating revenues increased by 3.3 percent or \$13.8 million to \$435.8 million from \$422.0 million in 2013. Operating expenses increased by 4.5 percent or \$12.6 million to \$290.8 million in 2014 from \$278.2 million in 2013.

In 2013, operating revenues increased by 10.5 percent or \$40.1 million to \$422.0 million from \$381.9 million in 2012. Operating expenses increased by 10.2 percent or \$25.8 million from \$252.4 million in 2012.

The operating revenues and expenses were driven by:

- In 2014, sewer disposal fees increased \$11.3 million or 3.2 percent to \$364.6 million from \$353.2 million in 2013 due to an increase in the number of RCE's, higher capacity charge revenue, increased sales of renewable energy, and use of the rate stabilization fund.
- Chemical expenses decreased by 7.6 percent or about \$573 thousand in 2014 to \$7.0 million primarily due to reduced spending on carbon in 2014. Chemical expenses increased by 14.5 percent or about \$1.0 million in 2013 to \$7.5 million.
- Utility and Service expenses increased by 1.8 percent or \$517 thousand to \$28.6 million for 2014 from \$28.1 million in 2013. Utility and Service expenses decreased by 0.4 percent or \$994 thousand to \$28.1 million for 2013 from \$28.2 million in 2012. Electricity expenses increased by 5.4 percent or \$689 thousand to \$13.5 million in 2014 after decreasing by 5.1 percent or \$692 thousand to \$12.8 million in 2013. Electricity usage was driven up in 2014 due to influent storm water from heavy rains.
- Intergovernmental expenses decreased by 5.1 percent or \$1.7 million in 2014 to \$31.6 million from \$33.3 million in 2013, due primarily to a reduction in equipment rental. Intergovernmental expenses increased by 5.0 percent or \$1.5 million in 2013 to \$33.3 million from \$31.8 million in 2012. In general, contributors to increases here are reflected in central charges relating to support of the 2012 Oracle system conversion.
- Water Quality collected a monthly sewage treatment charge of \$39.79 per RCE in 2014 and 2013, and in 2012, \$36.10. Sewer disposal revenues before rate stabilization increased by 1.0 percent or \$3.6 million in 2014 to \$346.6 million. Sewer disposal revenues before rate stabilization increased by 11.6 percent or \$35.8 million to \$343.0 million in 2013 from \$307.2 million in 2012.
- Other operating revenues, including capacity charges for new customers and other treatment charges, increased by 3.6 percent or \$2.5 million in 2014 to \$71.2 million from \$68.7 million in 2013. These revenues increased by 13.0 percent or \$7.9 million in 2013 to \$68.7 million from \$60.8 million in 2012. Capacity charge early payoff revenues were 23.5 percent or \$14.0 million of total capacity charge revenues in 2014, while in 2013, capacity charge early payoff revenues were 30.9 percent or \$18.1 million of the annual total. Actual new capacity charge connections were 10,767 in 2014 and 7,224 in 2013.

KING COUNTY WATER QUALITY ENTERPRISE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

- Net non-operating revenues and expenses increased by 3.1 percent or \$4.5 million to \$149.8 million in 2014 from \$145.3 million in 2013. Contributors to changes in the numbers were increased investment earnings offset by loss on disposal of capital assets. Net non-operating revenues and expenses increased by 6.6 percent or \$9.0 million to \$145.3 million in 2013 from \$136.3 million in 2012.
- No capital grant revenues were received from federal and state agencies in 2014 reflecting a decrease of \$300 thousand from 2013. Capital grant revenues received from federal and state agencies increased by \$300 thousand in 2013 from zero in 2012. Low interest loans have largely replaced grants as the primary method of state agency support in recent years.
- Depreciation and amortization expense increased by 3.2 percent or \$5.0 million in 2014 compared to 17.4 percent or \$23.6 million in 2013. Completed capital projects contribute to increases in depreciation expense.

CAPITAL ASSETS

At December 31, 2014, Water Quality's investment in capital assets, net of accumulated depreciation, was \$4,122.9 million, reflecting a decrease of \$5.5 million or 0.13 percent less than the balance at December 31, 2013. This decrease represents plant in service retirements and an increase in depreciation from Brightwater Treatment Plant and Conveyance capitalizations. Capital assets net decrease from December 31, 2012 to December 31, 2013 was \$12.8 million or 0.31 percent.

Large 2014 construction project expenditures include:

- \$20.9 million for Magnolia CSO Control & Improvements
- \$11.3 million for Murray CSO Control & Improvements
- \$9.1 million for West Point Dewatering & Energy Improvements
- \$8.2 million for West Point Influent Screen Improvements
- \$7.5 million for North Beach CSO Control & Improvements

Large 2013 construction project expenditures include:

- \$6.2 million for West Point Liquids Control System Replacement
- \$7.7 million for West Point Influent Screen Improvements
- \$11.2 million for Barton Pump Station Upgrade
- \$16.3 million for Ballard Siphon Replacement
- \$19.8 million spent toward the Brightwater Conveyance project

For more detailed information on capital assets, refer to Note 6 in the financial statements.

KING COUNTY WATER QUALITY ENTERPRISE FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS

DEBT ADMINISTRATION

Water Quality issued \$75.0 million of sewer revenue and refunding bonds in June 2014 with an average life of 30.6 years at an average rate of 5.0 percent and an effective rate of 4.2 percent, and \$192.5 million of revenue refunding bonds in August 2014 with an average life of 14.5 years at an average rate of 4.35 percent and effective rate of 3.36 percent.

Water Quality issued \$122.9 million of revenue refunding bonds in April 2013 with an average life of 12.8 years at an average rate of 4.97 percent and an effective rate of 3.3 percent and \$74.9 million of revenue and refunding bonds in October 2013 with an average life of 14.6 years at an average rate of 4.91 percent and effective rate of 4.05 percent.

Water Quality received \$22.3 million in low-interest loans from the State of Washington in 2014 and \$19.6 million in 2013. The new loans carry below-market rates between 0.5 percent and 2.82 percent with repayment terms up to 20 years.

Water Quality has \$2.8 billion of sewer revenue bonds and variable rate revenue bonds outstanding at the end of 2014 and had \$2.9 billion outstanding at the end of 2013. Revenue bonds are repaid from and secured by a pledge of earnings, revenues and money received by Water Quality from or on account of operation of the sewer system, including receipts from sewage treatment fees, and other income of Water Quality. Revenue bonds are not guaranteed by the full faith and credit of King County.

At the end of 2014, Water Quality has \$780.0 million of general obligation bonds and variable rate general obligation bonds outstanding and had \$788.0 million of general obligation bonds and variable rate general obligation bonds outstanding at the end of 2013. Although repaid from a portion of receipts from sewage treatment fees and other income, the full faith and credit of King County guarantees repayment of principal and interest on general obligation bonds.

King County received long-term ratings of AAA from Standard and Poor's for the multimodal limited tax general obligation bond issued in January 2010 and "Aa1" from Moody's Investor's with short-term ratings of "VMIG 1" and "A-1+". At the time of the issuance of the sewer revenue bonds in 2014 and 2013, Water Quality's bond ratings were:

Moody's Investor's Service

Aa2

Standard & Poor's

AA+

As required by bond covenant, Water Quality maintains a bond reserve account, which is funded by cash balances. At December 31, 2014, the cash balance in the reserve account was \$174.1 million and \$175.5 million at the end of 2013. In addition to bond covenant reserves, Water Quality also maintains financial policy reserves. At December 31, 2014 and 2013, respectively, the rate stabilization, liquidity, and asset management financial policy reserves totaled \$66.7 million and \$84.3 million.

For more detailed information on debt, refer to the notes to the financial statements.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS**

DEBT SERVICE COVERAGE RATIOS

| | <u>FY 2014</u> | <u>FY 2013</u> |
|-------------|-----------------------|-----------------------|
| Parity Debt | 1.44 | 1.42 |
| Total Debt | 1.33 | 1.33 |

Two debt service coverage ratios closely monitored by bond rating agencies are coverage on parity debt and coverage on total debt. By bond ordinance, Water Quality sets sewer rates at a level adequate to provide net revenue equal to at least 1.15 times the annual debt service requirement on parity debt. Water Quality has an adopted policy to achieve a ratio of at least 1.25 on parity debt or 0.10 above the ratio required by bond ordinance. Since 2001, Water Quality established a minimum coverage policy of 1.15 on total debt to further strengthen coverage performance.

REQUESTS FOR INFORMATION

This financial report is designed to provide an overview of Water Quality's financial condition as of the years ended December 31, 2014 and 2013. Questions concerning this report or requests for additional information should be addressed to Pete Anthony, Chief Accountant for King County, 500 Fourth Avenue, Room 653, Seattle, WA 98104.

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF NET POSITION
(in thousands)

| | December 31, | |
|--|---------------------|---------------------|
| | 2014 | 2013 |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 204,064 | \$ 262,151 |
| Restricted cash and cash equivalents | 146,651 | 148,177 |
| Accounts receivable, net | 44,081 | 36,222 |
| Due from other funds | 1,150 | 3,994 |
| Due from other governments, net | 3,782 | - |
| Inventory of supplies | 7,672 | 7,252 |
| Prepayments | 85 | 59 |
| | <u>407,485</u> | <u>457,855</u> |
| NONCURRENT ASSETS | | |
| Cash and cash equivalents | <u>216,868</u> | <u>236,072</u> |
| Capital assets | | |
| Building and land improvements | 1,939,307 | 1,895,310 |
| Artwork | 5,572 | 5,579 |
| Infrastructure and right of way | 2,266,997 | 2,154,089 |
| Plant in service and other equipment | 1,074,386 | 1,081,146 |
| Less accumulated depreciation | <u>(1,700,893)</u> | <u>(1,575,767)</u> |
| | 3,585,369 | 3,560,357 |
| Land and easements | 254,713 | 251,860 |
| Construction work in progress | <u>282,785</u> | <u>316,142</u> |
| | <u>4,122,867</u> | <u>4,128,359</u> |
| Other noncurrent | | |
| Prepayments | 425 | 863 |
| Regulatory assets - environmental remediation | 63,303 | 59,591 |
| Other utility assets, net of amortization | 29,835 | 31,001 |
| Other assets | <u>4,200</u> | <u>4,438</u> |
| | <u>97,763</u> | <u>95,893</u> |
| Total assets | 4,844,983 | 4,918,179 |
| DEFERRED OUTFLOWS OF RESOURCES | | |
| Deferred amount on refunding | <u>101,942</u> | <u>92,008</u> |
| TOTAL ASSETS AND DEFERRED OUTFLOWS OF RESOURCES | <u>\$ 4,946,925</u> | <u>\$ 5,010,187</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF NET POSITION (CONTINUED)
(in thousands)

| | December 31, | |
|--|-------------------|-------------------|
| | 2014 | 2013 |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 27,283 | \$ 30,204 |
| Retainage payable | 2,352 | 881 |
| Due to other funds | - | 5 |
| Interest payable | 79,115 | 81,418 |
| Wages and benefits payable | 2,210 | 4,256 |
| Compensated absences | 565 | 572 |
| Taxes payable | 17 | 7 |
| Unearned revenue | 1,628 | 1,328 |
| Notes payable | 100,000 | 100,000 |
| State loans payable | 11,133 | 9,323 |
| General obligation bonds payable | 9,000 | 8,750 |
| Revenue bonds payable | 51,615 | 48,880 |
| Environmental remediation costs | 5,632 | 5,715 |
| Deposit and other liability | 144,299 | 144,302 |
| | <u>434,849</u> | <u>435,641</u> |
| NONCURRENT LIABILITIES | | |
| Compensated absences, net | 10,919 | 10,740 |
| Other post-employment benefits | 1,351 | 1,195 |
| State loans payable, net | 147,920 | 137,349 |
| General obligation bonds payable, net | 770,505 | 779,505 |
| Revenue bonds payable, net | 2,762,190 | 2,817,205 |
| Unamortized bond premium and discount | 190,669 | 177,554 |
| Environmental remediation costs, net | 39,168 | 38,845 |
| | <u>3,922,722</u> | <u>3,962,393</u> |
| Total liabilities | 4,357,571 | 4,398,034 |
| DEFERRED INFLOWS OF RESOURCES | | |
| Regulatory credit - rate stabilization | 34,250 | 52,250 |
| TOTAL LIABILITIES AND DEFERRED INFLOWS OF RESOURCES | <u>4,391,821</u> | <u>4,450,284</u> |
| NET POSITION | | |
| Net investments in capital assets | 210,360 | 206,943 |
| Restricted for | | |
| Debt service | 182,618 | 183,822 |
| Regulatory assets and environmental liabilities | 22,704 | 19,469 |
| Unrestricted | 139,422 | 149,669 |
| Total net position | <u>\$ 555,104</u> | <u>\$ 559,903</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
(in thousands)

| | Years Ended December 31, | |
|---|--------------------------|-------------------|
| | 2014 | 2013 |
| OPERATING REVENUES | | |
| Sewage disposal fees | \$ 364,591 | \$ 353,200 |
| Other operating revenues | 71,197 | 68,786 |
| Total operating revenues | <u>435,788</u> | <u>421,986</u> |
| OPERATING EXPENSES | | |
| Sewage treatment, disposal, and transmission | 100,473 | 94,081 |
| General and administrative | 23,728 | 23,102 |
| Environmental related amortization | 2,581 | 2,041 |
| Depreciation and amortization | 163,976 | 158,947 |
| Total operating expenses | <u>290,758</u> | <u>278,171</u> |
| OPERATING INCOME | <u>145,030</u> | <u>143,815</u> |
| NONOPERATING REVENUES (EXPENSES) | | |
| Investment earnings | 3,856 | 272 |
| Interest expense | (150,007) | (150,706) |
| Loss on disposal and impairment of capital assets | (3,001) | (792) |
| Other | (677) | 5,928 |
| Total nonoperating expenses | <u>(149,829)</u> | <u>(145,298)</u> |
| LOSS BEFORE GRANTS AND CONTRIBUTIONS | (4,799) | (1,483) |
| CAPITAL GRANT REVENUES | <u>-</u> | <u>260</u> |
| CHANGE IN NET POSITION | (4,799) | (1,223) |
| NET POSITION | | |
| Beginning of year | <u>559,903</u> | <u>561,126</u> |
| End of year | <u>\$ 555,104</u> | <u>\$ 559,903</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF CASH FLOWS
(in thousands)

| | Years Ended December 31, | |
|---|--------------------------|-------------------|
| | 2014 | 2013 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Cash received from customers | \$ 414,909 | \$ 423,020 |
| Cash payments to suppliers for goods and services | (79,950) | (81,251) |
| Cash payments for employee services | (48,703) | (38,836) |
| Settlement receipts | - | 144,299 |
| Other payments | (5,957) | (5,117) |
| Net cash provided by operating activities | <u>280,299</u> | <u>442,115</u> |
| CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES | | |
| Operating grant and subsidy received | 65 | 72 |
| Transfers out | (173) | (70) |
| Interfund loan principal paid | - | (20,158) |
| Assistance to other agencies | (17) | (103) |
| Net cash used in noncapital financing activities | <u>(125)</u> | <u>(20,259)</u> |
| CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES | | |
| Acquisition of capital and other utility assets | (154,085) | (134,409) |
| Proceeds from disposal of capital assets | 23 | 19 |
| Principal paid on capital debt | (67,331) | (51,593) |
| Interest paid on capital debt | (169,072) | (164,300) |
| Proceeds of new bond issuance | 5,275 | 52,990 |
| Proceeds of state loans | 22,343 | 19,597 |
| Capital grants received | - | 260 |
| Net cash used in capital and related financing activities | <u>(362,847)</u> | <u>(277,436)</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Interest on investments | <u>3,856</u> | <u>272</u> |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (78,817) | 144,692 |
| CASH AND CASH EQUIVALENTS | | |
| Beginning of year | <u>646,400</u> | <u>501,708</u> |
| End of year | <u>\$ 567,583</u> | <u>\$ 646,400</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
STATEMENTS OF CASH FLOWS (CONTINUED)
(in thousands)

| | Years Ended December 31, | |
|--|--------------------------|-------------------|
| | 2014 | 2013 |
| RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES | | |
| Operating income | \$ 145,030 | \$ 143,815 |
| Adjustments to reconcile operating income to net cash provided by operating activities | | |
| Depreciation and amortization | 163,976 | 158,947 |
| Other nonoperating revenue | 1,646 | 6,279 |
| Changes in assets | | |
| Accounts receivable | (7,859) | 6,670 |
| Due from other funds | 2,892 | (2,027) |
| Inventory of supplies | (420) | (280) |
| Prepayments | (40) | 127 |
| Other assets | (3,476) | (12,435) |
| Changes in liabilities | | |
| Accounts payable | (2,783) | (1,944) |
| Retainage payable | (17) | (36) |
| Due to other funds | (5) | (844) |
| Taxes payable | 10 | 4 |
| Unearned revenue | 300 | 463 |
| Wages and benefits payable | (1,523) | (150) |
| Compensated absences | 172 | 63 |
| Other post-employment benefits | 156 | 155 |
| Other liabilities | 240 | 153,658 |
| Changes in deferred inflows of resources | | |
| Rate stabilization | (18,000) | (10,350) |
| Total adjustments | 135,269 | 298,300 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | <u>\$ 280,299</u> | <u>\$ 442,115</u> |

NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES:

Water Quality issued bonds in 2014 to refund debt issued from 2004 to 2008. The \$295.1 million proceeds were placed in escrow for the defeasance and purchase of \$270.9 million of outstanding bond principal and \$22.8 million of interest.

Water Quality issued bonds in 2013 to refund debt issued from 2003 to 2006. The \$171.2 million proceeds were placed in escrow for the defeasance of \$163.1 million of outstanding bond principal and \$8.1 million of interest.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 1 - Operations and Accounting Policies

Summary of Operations - The King County Water Quality Enterprise Fund (Water Quality) is an enterprise fund operated by the King County Department of Natural Resources and Parks in accordance with Chapter 35.58 of the Revised Code of Washington (RCW) to provide sewage treatment and water pollution abatement services to the urbanized areas of King County, Washington (the County).

Water Quality is an integral part of the County reporting entity and is included, as an enterprise fund, in the County's comprehensive annual financial report. As an enterprise fund, Water Quality is funded and operated separately from other operations of the County. Revenues, bond proceeds, and grants are restricted by purpose. Accordingly, Water Quality maintains separate accounting records and issues stand-alone financial statements.

Water Quality has long-term sewage disposal agreements with the cities and sewer districts that operate sewage collection systems within its service area. The monthly sewage disposal charge to the contracting cities and districts is based on Water Quality's estimated annual monetary requirements, including operating costs and debt service. Revenues from Water Quality's largest customer, the City of Seattle (Seattle Public Utilities), represent approximately 40 percent of total sewage disposal fees in 2014 and in 2013.

Water Quality purchases goods and services from other County agencies, including reimbursement of the County's general fund for a share of general government. Expenses incurred in doing business with other County agencies amounted to \$31.6 million and \$33.3 million in 2014 and 2013, respectively.

Significant Accounting Policies - Water Quality is accounted for using the flow of economic resources measurement focus similar to that of a private enterprise organized for profit. Water Quality's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units using the accrual basis of accounting. Under this method, revenues are recorded when earned, and expenses are recorded at the time liabilities are incurred. Water Quality, regardless of the timing of cash flows, applies all applicable Governmental Accounting Standards Board (GASB) pronouncements.

- a. *Cash and Cash Equivalents* - Water Quality considers as cash and cash equivalents all balances held with the King County Treasurer in the King County Investment Pool (the Pool), cash with escrow agents or held in trust, and petty cash. Unrealized gain or loss on Water Quality's proportionate share of the Pool is reported as a component of investment earnings.
- b. *Due From and To Other Funds, Interfund Loans and Advances* - Due from and to other funds consists of current receivables and payables from or to other funds within the County. They typically arise from interfund goods and service transactions and reimbursements.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 1 - Operations and Accounting Policies (Continued)

Interfund loans receivable and payable or advances from and to other funds represent authorized short-term and long-term, respectively, lending and borrowing arrangements within the County.

- c. *Inventory of Supplies* - Inventory is recorded at the lower of cost or market using the weighted-average cost method. Materials and supplies are expensed as consumed. Inventory is written off in the year that it is determined obsolete.
- d. *Restricted Assets* - In accordance with Water Quality's bond resolutions, state law, King County codes, or other agreements, separate restricted assets have been established. These assets are restricted for specific purposes, including bond and state loan reserves.
- e. *Capital Assets* - Capital assets are stated at cost, less accumulated depreciation and amortization. Water Quality's capitalization threshold is: equipment at \$5 thousand; software and intangible assets at \$500 thousand, and buildings and improvements at \$100 thousand. Provision for depreciation and amortization are made on a straight-line basis over the estimated useful lives of Water Quality's capital assets as follows:

| Description | Estimated Useful Life |
|---|-----------------------|
| Buildings and improvements other than building | 10 - 75 years |
| Cars, vans, and trucks | 5 - 10 years |
| Data processing equipment | 3 - 10 years |
| Heavy equipment | 5 - 25 years |
| Sewer lines | 20 - 50 years |
| Shop equipment | 5 - 20 years |
| Software | 3 - 10 years |
| Intangibles | 35 years |

Water Quality capitalizes certain interest income and expense related to borrowings until the assets are ready for their intended use. The amount capitalized is the difference between the interest revenue and interest expense associated with the applicable tax free borrowings. Total interest incurred was \$165.5 million and \$165.7 million, respectively, during the years ended December 31, 2014 and 2013, respectively, of which \$11.5 million and \$11.3 million, respectively, was capitalized.

Repairs and maintenance are expensed as incurred; major renewals, replacements, and betterments are capitalized.

Water Quality annually reviews long-lived assets for impairment to determine whether any events or circumstances indicate the carrying value of the assets may not be recoverable.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 1 - Operations and Accounting Policies (Continued)

- f. *Compensated Absences* - Employees earn vacation based upon their date of hire and years of service. They may accumulate a maximum of 480 hours or as bargained for by represented employees. Unused vacation at retirement or normal termination is considered vested and payable to the employee. Employees also earn up to 12 days of sick leave per year and may accumulate sick leave balances without limit. Employees or their beneficiaries are paid 35 percent of the accrued unused sick leave upon retirement or death. No amounts are paid for unused sick leave upon termination. Vacation pay and a portion of sick leave liabilities, including payroll taxes, are accrued.

Water Quality accrues estimated excess compensation liabilities to the Washington State Department of Retirement Systems based on an employee's accrued vacation and sick leave. An excess compensation liability is incurred when an employee whose retirement benefits are based in part on excess compensation receives a termination or severance payment defined by the State as excess compensation. This includes, but is not limited to, a cash-out of unused annual leave in excess of 240 hours and a cash-out of any other form of leave.

- g. *Rebatable Arbitrage* - Water Quality's tax-exempt debt is subject to arbitrage restrictions as defined by the Internal Revenue Code. Arbitrage occurs when the funds borrowed at tax-exempt rates of interest are invested in higher yielding taxable securities. These interest earnings in excess of interest expense must be remitted to the federal government except when spending exceptions rules are met. The liability is recognized during the period the excess interest is earned.
- h. *Deferred Outflows and Inflows of Resources* - Deferred outflows of resources represent consumption of resources that is applicable to future reporting periods and deferred inflows of resources represent acquisition of resources that is applicable to future reporting periods.
- i. *Operating and Nonoperating Revenues and Expenses* - Operating revenues result from exchange transactions of Water Quality's activities. Expenses associated with providing wastewater treatment services and operating Water Quality's treatment facilities are considered operating. Nonoperating revenues result from nonexchange transactions such as operating subsidies and investment earnings.

Water Quality provides water treatment services to cities and sewer districts and recognizes revenue when such service is provided. Additionally, the capacity charge revenue is generated from new connections to the sewer system. Both water treatment service and capacity charge rates are authorized by ordinances passed by the King County Council. Water treatment service and capacity charge revenues are recorded through cycle billings rendered to customers monthly. Water Quality accrues and records unbilled water service and capacity charge revenues in the financial statements for services provided from the date of the last billing to year end.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 1 - Operations and Accounting Policies (Continued)

- j. *Debt-related Amortization* - Bond premiums, discounts and refunding losses and gains are amortized over the life of the bonds using the outstanding principal balance method.
- k. *Capital Grant Revenues* - Pursuant to GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, grant revenues are reported separately from operating and nonoperating revenues as capital grant revenues. Water Quality received capital grant revenues of \$260 thousand for the year ended December 31, 2013.
- l. *Net Position* - Resources set aside for debt services and other obligations, net of related liabilities, are classified as restricted net position on the statements of net position as their use is limited by externally-imposed restrictions. Net investments in capital assets are reported as a separate component of net position. Any net position not subject to classification as restricted or invested in capital assets are reported as unrestricted.
- m. *Use of Estimates* - The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements. Specific estimates have been made in the areas of allowance for uncollectible accounts, environmental remediation costs, useful lives of capital assets, and future interest rates. Actual results could differ from these estimates.
- n. *Reclassification* - Certain reclassifications have been made to the prior year statements to conform to the current year presentation.

New Accounting Standards - The following GASB pronouncements are effective for 2014 financial reporting of Water Quality.

GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Guarantees*, was issued in April 2013. The standard provides guidance on accounting and financial reporting by state and local governments that extend and receive nonexchange financial guarantees. The statement is effective for periods beginning after June 15, 2013. It was early adopted in 2013 and had no impact on Water Quality's financial statements.

GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, establishes accounting and financial reporting related to government combinations and disposals of government operations. There were no transactions in Water Quality during 2014 that relate to this new guidance. This statement is effective for government combinations and disposals of government operations occurring in financial reporting periods beginning after December 15, 2013.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 1 - Operations and Accounting Policies (Continued)

GASB Statement No. 67, *Financial Reporting for Pension Plans – An amendment of GASB Statement 25*, replaces the requirements of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 50, *Pension Disclosures*, as they relate to pension plans that are administered through trusts or equivalent arrangements that meet certain criteria. This statement does not directly apply to Water Quality since its pension benefits are administered by the Washington Public Employees Retirement System (PERS) and other pension plan trusts. The statement is effective for financial statements for fiscal years beginning after June 15, 2013.

GASB Statement No. 65, *Items Previously Reported as Asset and Liabilities*, was issued in March 2012. This statement establishes accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities. The requirements of this statement are effective for financial statements for periods beginning after December 15, 2012. Water Quality adopted the standard in 2013 and restated its prior financial statements to comply with the requirements.

Note 2 - Deposits and Investments

The King County Treasurer is the custodian of Water Quality's cash. Water Quality's cash on deposit with the King County Treasurer is pooled with cash from other County funds and other jurisdictions and are either deposited in the County's bank account or invested by the County. The King County Investment Pool (the Pool) functions essentially as a demand deposit account where Water Quality receives an allocation of its proportionate share of pooled earnings as interest.

The Pool is administered by the King County Treasury Operations Section and is not registered with the Securities and Exchange Commission (SEC) as an investment company. Oversight is provided by the King County Executive Finance Committee (EFC) pursuant to RCW 36.29.020. The EFC consists of the Chair of the County Council, the County Executive, the Director of Office of Performance, Strategy and Budget, and the Director of the Finance and Business Operations Division, or their designees. All investments are subject to written policies adopted by the EFC. The EFC reviews Pool performance monthly.

The County has deposit and investment policies addressing risks that have the potential to result in losses of deposits and investments. All deposits not insured by the Federal Depository Insurance Corporation (FDIC) are fully collateralized by the Public Deposit Protection Commission of the State of Washington (PDPC), a statutory authority established under chapter 39.58 RCW that governs public depositories and provides that "All public funds deposited in public depositories, including investment deposits and accrued interest thereon, shall be protected against loss, as provided in the chapter." Effective July 1, 2009, all public depositories were required to pledge securities at 100% of their public deposits not covered by FDIC insurance.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 2 - Deposits and Investments (Continued)

The PDPC constitutes a multiple financial institution collateral pool that can make pro rata assessments to all public depositories within the state for their public deposits. PDPC protection is of the nature of collateral, not of insurance. The custodial credit risk for deposits is the risk that Water Quality's deposits may not be returned to it in the event of a bank failure. Assessing Water Quality's risk exposure, Water Quality's cash and cash equivalents balance of \$567.6 million and \$646.4 million were fully insured and collateralized as of December 31, 2014 and 2013, respectively.

Credit Risk - Investments: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligation. As of December 31, 2014, the Pool was not rated by a Nationally Recognized Statistical Rating Organization (NRSRO). In compliance with state statutes, Pool policies authorize investments in U.S. Treasury securities, U.S. agency securities and mortgage-backed securities, municipal securities (rated at least "A" by two NRSROs), commercial paper (rated at least the equivalent of "A-1" by two NRSROs), certificates of deposit issued by qualified public depositories, repurchase agreements, and the Local Government Investment Pool managed by the Washington State Treasurer's office. The main Pool's policies limit the maximum amount that can be invested in various securities. At 2014 and 2013 year-end the Pool was in compliance. The Pool's actual composition, as of December 31, 2014, consisted of Repurchase Agreements, 2.7 percent, Commercial Paper, 3.1 percent, U.S. Agency Discount Notes, 10.7 percent, Bank Notes, 3.3 percent, U.S. Treasury Notes, 35.1 percent, U.S. Agency Notes, 34.3 percent, U.S. Agency Collateralized Mortgage Obligations, 0.2 percent, and the State Treasurer's Investment Pool, 10.6 percent. The December 31, 2013 composition comprised Repurchase Agreements, 0.9 percent, Commercial Paper, 0.5 percent, U.S. Agency Discount Notes, 7.5 percent, U.S. Treasury Notes, 21.5 percent, U.S. Treasury Zero Coupon Notes, 0.5 percent, U.S. Agency Notes, 50.6 percent, U.S. Agency Collateralized Mortgage Obligations, 0.2 percent, and the State Treasurer's Investment Pool, 18.3 percent.

Custodial Credit Risk - Investments: Custodial credit risk is the risk that in the event of the failure of the counterparty, the County will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. County policy mandates that all security transactions, including repurchase agreements, are settled "delivery versus payment." This means that payment is made simultaneously with the receipt of the security. These securities are delivered to the County's safekeeping bank or its tri-party custodian banks. Exempt from the DVP policy are Certificates of Deposits (CDs) and funds placed with the State of Washington Local Government Investment Pool.

Concentration of Credit Risk - Investments: Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issue. At 2014 year-end the Pool had concentrations greater than 5 percent of the total investment pool portfolio in the following issues: Federal Home Loan Mortgage Corporation-11.3 percent, Federal National Mortgage Association-13.1 percent, Federal Home Loan Bank-13.6 percent, Federal Farm Credit Bank-7.1 percent and Wells Fargo Bank-5.0 percent. The issues with concentrations greater than 5 percent of the pool portfolio at 2013 year-end were as follows: Federal Home Loan Mortgage Corporation-14.7 percent, Federal National Mortgage Association-13.7 percent, Federal Home Loan Bank-20.5 percent, and Federal Farm Credit Bank-9.3 percent.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 2 - Deposits and Investments (Continued)

Interest Rate Risk - Investments: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Through its investment policy, the County manages its exposure to fair value losses arising from increasing interest rates by setting maturity and effective duration limits for the Pool. The policy limit for the Pool's maximum effective duration is 1.5 years, and 40 percent of the Pool's total value in securities must have a maturity of 12 months or fewer. Securities in the portfolio cannot have an average life greater than five years at purchase. The combined effective duration of the liquidity and core portfolios was 1.261 years and 1.299 years, respectively, at December 31, 2014 and 2013.

The Pool has four impaired commercial paper investments which have completed enforcement events. The County completed the restructuring of three of the four securities in 2008 and completed the restructuring of the fourth security in 2009. Between 2008 and 2010, the County initiated lawsuits seeking recovery for losses associated with all four of the impaired investments. In 2012, the County settled the litigation concerning Mainsail and Victoria, and executed a settlement with three of the defendants in the lawsuits concerning Rhinebridge. The net settlement payments have been distributed to each pool participant. In 2013, the County received final settlement payments for the litigation concerning Rhinebridge and Cheyne and has distributed the net settlement payments to each pool participant. The majority of remaining settlement amounts are associated with VFNC Trust (Victoria). During 2014, the County received cash distributions monthly from VFNC Trust and distributed them to pool participants. The monthly distribution is expected to continue for at least the next five years. The County chose not to discount these future cash flows because of extremely low interest rates.

Water Quality's share of the unrealized loss from the Pool's impaired investments was \$485 thousand at December 31, 2014 and \$609 thousand at December 31, 2013. Losses from impaired investments are offset against other investment earnings.

Note 3 - Restricted Assets

A significant portion of Water Quality's assets is restricted as to use by legal and contractual provisions and by fiscal management policy. Restricted assets comprise \$363.5 million at December 31, 2014 and \$384.2 million at December 31, 2013 to comply with bond covenants and other requirements.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 3 - Restricted Assets (Continued)

The details of restricted and unrestricted cash and cash equivalents as of December 31, 2014 and 2013 are as follows (in thousands):

| | <u>2014</u> | <u>2013</u> |
|--|-------------------|-------------------|
| Unrestricted Cash and Cash Equivalents | | |
| Operating Funds | \$ 21,411 | \$ 21,545 |
| Construction Funds | 11,417 | 35,901 |
| Bond Proceeds Committed to Construction | - | 35,753 |
| Bond Funds | 138,816 | 136,808 |
| Policy Reserves | <u>32,420</u> | <u>32,144</u> |
| Total Unrestricted Cash and Cash Equivalents | <u>204,064</u> | <u>262,151</u> |
| Restricted Cash and Cash Equivalents | | |
| Bond Reserves | 174,094 | 175,547 |
| SRF Loan Reserves | 8,524 | 8,275 |
| Retainage | 2,352 | 881 |
| Rate Stabilization Reserve | 34,250 | 52,250 |
| Legally Restricted Funds | <u>144,299</u> | <u>147,296</u> |
| Total Restricted Cash and Cash Equivalents | <u>363,519</u> | <u>384,249</u> |
| Total Cash and Cash Equivalents | <u>\$ 567,583</u> | <u>\$ 646,400</u> |

Note 4 - Risk Management

Water Quality is exposed to a wide range of risks of loss, including those related to tort; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters.

Water Quality participates in three County internal service funds to account for and finance its (1) property/casualty, (2) workers' compensation, and (3) employee medical and dental benefits, through self-insurance programs. The County contracts with a plan administrator to process medical and dental claims. County fund/claims managers, together with the Civil Division of the King County Prosecuting Attorney's Office, are responsible for processing all tort and workers' compensation claims.

During 2014 and 2013, Water Quality claims paid by the Insurance Fund of King County were \$1.5 million and \$1.0 million, respectively. In the past three years there was no occurrence that resulted in payment in excess of the self-insured retention of \$7.5 million.

KING COUNTY WATER QUALITY ENTERPRISE FUND NOTES TO FINANCIAL STATEMENTS

Note 4 - Risk Management (Continued)

Claims settlements and loss expenses are accrued in the three internal service funds for the estimated settlement value of both reported and unreported claims. These funds are responsible for collecting interfund premiums from insured funds and departments, for paying claim settlements, and for purchasing certain policies. The County's internal service funds assess premiums attributable to Water Quality on the basis of claims experience, actuarial evaluation of future claims risk, and adequacy of available reserves. Premiums are recorded as an expense in the year paid or accrued.

Water Quality retains all risk associated with environmental claims.

Note 5 - Long-Term Liabilities and Notes Payable

Sewer Revenue Bonds - As of December 31, 2014, bonds outstanding include \$2,813.8 million of serial and term bonds maturing from January 1, 2015 through January 1, 2052, bearing interest at stated rates of 1.00 percent to 5.75 percent per annum.

On July 8, 2014, the County issued \$75.0 million in sewer revenue refunding bonds, 2014A, with an effective interest cost of 4.2 percent to purchase \$75.0 million of outstanding sewer revenue bonds, 2007, with an average coupon interest rate of 5.0 percent. The reacquisition price exceeded the net carrying amount of the old debt by \$3.5 million. The transaction resulted in an economic gain of \$5.3 million, the difference between the present values of the old and new debt service payments and the difference between the issue price of the 2014A bond and the purchase price of the 2007 bond.

On August 12, 2014, the County issued \$192.5 million in sewer revenue bonds, 2014B, with an effective interest cost of 3.4 percent to advance refund \$195.9 million of outstanding sewer revenue bonds, 2004B, 2006-1, 2006-2, 2007 and 2008 bonds, with an average coupon interest rate of 5.0 percent. The reacquisition price exceeded the net carrying amount of the old debt by \$15.8 million. This advance refunding was undertaken to reduce total debt service payments by \$32.0 million over the life of the bonds, resulting in an economic gain (difference between the present values of the old and new debt service payments) of \$20.1 million.

On April 9, 2013, Water Quality issued \$122.9 million in sewer revenue refunding bonds, Series A, with an effective interest rate of 3.3 percent to advance refund \$107.0 million of outstanding sewer revenue bonds, Series 2003 and 2006, and \$28.9 million of limited tax GO (Sewer Revenue) bonds, Series 2005A, with an average coupon interest rate of 4.9 percent. The reacquisition price exceeded the net carrying amount of the old debt by \$5.0 million. This advance refunding was undertaken to reduce total debt service payments by \$35.3 million over the life of the bonds, resulting in an economic gain (difference between the present values of the old and new debt service payments) of \$21.8 million.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

On October 29, 2013, Water Quality issued \$74.9 million in sewer revenue bonds, Series B, of which \$25.5 million was refunding with an effective interest rate of 2.6 percent to advance refund \$27.2 million of outstanding sewer revenue bonds, Series 2004B, with an average coupon interest rate of 4.4 percent. The reacquisition price exceeded the net carrying amount of the old debt by \$437 thousand. This advance refunding was undertaken to reduce total debt service payments by \$2.7 million over the life of the bonds, resulting in an economic gain (difference between the present values of the old and new debt service payments) of \$2.3 million.

Bond issues provide funding for Water Quality's construction plan. Certain serial bonds may not be redeemed prior to maturity; other bonds may be redeemed after the lapse of specific periods of time. Amounts from the sewer revenue bond fund may be used to purchase term bonds prior to maturity.

The bonds are secured by a pledge of the revenue of the sewer system subject to payment of all operating and maintenance expenses of the sewer system. Payments from revenues of Water Quality are required to be made to the sewer revenue bond fund to pay interest and retire serial or term bonds on or before maturity. The amount required in the cash reserves and surety policies are based on the highest year of debt service over the life of all outstanding revenue bonds. As of December 31, 2014, Water Quality is in compliance with the combined amount required for the reserve and surety policies. The following table summarizes Water Quality's revenue bonds (in thousands):

| | Final Maturity | Interest Rates | Original Issue Amount | Outstanding at December 31, 2014 |
|-----------------------------|-------------------|-------------------|-----------------------------|--|
| 2001A-B Jr Lien Variable | 1/1/32 | (variable) | \$ 100,000 | \$ 100,000 |
| 2006 Refunding | 1/1/36 | 5.00% | 124,070 | 24,070 |
| 2006 (2nd Series) Refunding | 1/1/36 | 3.50-5.00% | 193,435 | 128,765 |
| 2007 | 1/1/47 | 5.00% | 250,000 | 144,335 |
| 2008 | 1/1/48 | 5.00-5.75% | 350,000 | 309,750 |
| 2009 | 1/1/42 | 4.00-5.25% | 250,000 | 247,290 |
| 2010 | 1/1/50 | 2.00-5.00% | 334,365 | 323,355 |
| 2011 | 1/1/41 | 5.00-5.125% | 175,000 | 171,795 |
| 2011 Series B | 1/1/41 | 1.00-5.00% | 494,270 | 436,450 |
| 2011 Series C | 1/1/35 | 3.00-5.00% | 32,445 | 32,445 |
| 2011 Sewer Jr Lien Variable | 1/1/42 | (variable) | 100,000 | 100,000 |
| 2012A Refunding | 1/1/52 | 5.00% | 104,445 | 104,445 |
| 2012B Refunding | 1/1/35 | 4.00-5.00% | 64,260 | 64,260 |
| 2012C Refunding | 1/4/33 | 2.50-5.00% | 65,415 | 65,415 |
| 2012 Sewer Jr Lien Variable | 1/1/43 | (variable) | 100,000 | 100,000 |
| 2013A Refunding | 1/1/35 | 2.00-5.00% | 122,895 | 119,495 |
| 2013B Revenue and Refunding | 1/1/44 | 2.00-5.00% | 74,930 | 74,475 |
| 2014A Refunding | 1/1/47 | 5.00% | 75,000 | 75,000 |
| 2014B Refunding | 7/1/35 | 1.00-5.00% | 192,460 | 192,460 |
| | | | <u>\$ 3,202,990</u> | <u>\$ 2,813,805</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

General Obligation Bonds - As of December 31, 2014, bonds outstanding include \$779.5 million of serial and term bonds maturing January 1, 2015 through 2040, bearing interest at stated rates of 2.00 percent to 5.25 percent per annum.

Certain serial bonds cannot be redeemed prior to maturity; other bonds may be redeemed after the lapse of specific periods of time.

The following table summarizes Water Quality's general obligation bonds (in thousands):

| | Final Maturity | Interest Rates | Original Issue Amount | Outstanding at December 31, 2014 |
|--------------------------|-------------------|-------------------|-----------------------------|--|
| 2008 LTGO | 1/1/34 | 3.25-5.25% | \$ 236,950 | \$ 219,505 |
| 2009B LTGO | 7/1/39 | 5.00-5.25% | 300,000 | 294,105 |
| 2010A-B Multi-Modal LTGO | 1/1/40 | (variable) | 100,000 | 100,000 |
| 2012A LTGO | 1/1/25 | 2.00-5.00% | 68,395 | 67,755 |
| 2012B LTGO | 1/1/29 | 5.00% | 41,725 | 41,725 |
| 2012C LTGO | 1/1/34 | 5.00% | 53,405 | 53,405 |
| 2012F LTGO | 12/1/22 | 2.20% | 3,010 | 3,010 |
| | | | <u>\$ 803,485</u> | <u>\$ 779,505</u> |

State Loans - Water Quality has received loans from the Washington Department of Ecology under the Water Pollution Control State Revolving Fund Loan Program and the Washington Public Works Trust Fund. The loans require annual payments of principal and interest from 2015 through 2034 and bear interest at stated rates from 0.00 percent to 3.10 percent. As of December 31, 2014, the balance due on all state loans is \$159.1 million. Water Quality maintains separate cash reserves of \$8.5 million as of December 31, 2014. These reserves are treated as restricted, being required under the Revolving Fund Loan Program. At December 31, 2014, the required principal and interest payments for all classes of long-term debt are as follows (in thousands):

| Year(s) Beginning | Revenue Bonds | | General Obligation Bonds | | State Loans | | Total |
|----------------------|---------------------|---------------------|--------------------------|-------------------|-------------------|------------------|---------------------|
| | Principal | Interest | Principal | Interest | Principal | Interest | |
| January 1, 2015 | \$ 51,615 | \$ 132,362 | \$ 9,000 | \$ 38,146 | \$ 11,133 | \$ 3,009 | \$ 245,265 |
| January 1, 2016 | 52,110 | 131,172 | 9,420 | 37,708 | 11,625 | 2,822 | 244,857 |
| January 1, 2017 | 43,895 | 129,000 | 21,000 | 36,972 | 11,731 | 2,626 | 245,224 |
| January 1, 2018 | 49,485 | 126,909 | 22,030 | 35,894 | 11,916 | 2,427 | 248,661 |
| January 1, 2019 | 50,255 | 124,643 | 23,110 | 34,767 | 12,162 | 2,223 | 247,160 |
| January 1, 2020—2024 | 278,680 | 585,242 | 136,750 | 154,635 | 54,534 | 8,108 | 1,217,949 |
| January 1, 2025—2029 | 361,840 | 507,137 | 170,395 | 116,454 | 30,270 | 3,751 | 1,189,847 |
| January 1, 2030—2034 | 555,595 | 396,756 | 196,060 | 71,169 | 15,682 | 922 | 1,236,184 |
| January 1, 2035—2039 | 417,275 | 270,366 | 91,740 | 34,639 | - | - | 814,020 |
| January 1, 2040—2044 | 613,885 | 147,778 | 100,000 | 4,428 | - | - | 866,091 |
| January 1, 2045—2049 | 293,915 | 43,507 | - | - | - | - | 337,422 |
| January 1, 2050—2052 | 45,255 | 2,588 | - | - | - | - | 47,843 |
| | <u>\$ 2,813,805</u> | <u>\$ 2,597,460</u> | <u>\$ 779,505</u> | <u>\$ 564,812</u> | <u>\$ 159,053</u> | <u>\$ 25,888</u> | <u>\$ 6,940,523</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

The future annualized interest payments for the variable rate revenue bonds are based on an interest rate of 5.40 percent, which represents 90 percent of the Revenue Bond Index assumed by the County for long-term financial planning purposes.

Commercial Paper (Notes Payable) - In December 1995, Water Quality initiated a commercial paper program that gives Water Quality the ability to issue up to \$100.0 million. The program is supported by an annually renewable line of credit that expires November 30, 2015. As of December 31, 2014, \$100.0 million was issued and outstanding under this program. The commercial paper has maturities ranging between 61 and 92 days and is classified as a current liability of Water Quality's operating fund. Changes in short-term note payables for the year ended December 31, 2014 and 2013 were as follows (in thousands):

| | Balance January 1, 2014 | Additions | Reductions | Balance December 31, 2014 |
|------------------|-------------------------------|-------------------|---------------------|---------------------------------|
| Commercial paper | <u>\$ 100,000</u> | <u>\$ 411,110</u> | <u>\$ (411,110)</u> | <u>\$ 100,000</u> |
| | Balance January 1, 2013 | Additions | Reductions | Balance December 31, 2013 |
| Commercial paper | <u>\$ 100,000</u> | <u>\$ 544,440</u> | <u>\$ (544,440)</u> | <u>\$ 100,000</u> |

Variable Rate General Obligation and Revenue Bonds - The variable rate bonds, 2001 Series A and Series B revenue bonds are supported by a periodically renewable letter of credit that expires December 31, 2015. The variable rate bonds, 2010 Series A and Series B general obligation bonds are supported by a Standby Bond Purchase Agreement that expires November 3, 2017. The variable rate bonds, 2011 and 2012 Sewer Jr Lien VRDM, do not have a liquidity facility.

Financial Policy Reserves - In addition to bond reserves related to Sewer Revenue Bonds, Water Quality maintains liquidity and asset management reserves totaling \$32.4 million at December 31, 2014.

Compliance with Bond Resolutions - With respect to the year ended December 31, 2014, Water Quality complied with all financial covenants stipulated by its bond resolutions.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 5 - Long-Term Liabilities and Notes Payable (Continued)

Changes in Long-Term Liabilities - Long-term liability activity for the years ended December 31, 2014 and 2013 was as follows (in thousands):

| | Balance January 1, 2014 | Additions | Reductions | Balance December 31, 2014 | Due Within One Year |
|--------------------------------|-------------------------------|-------------------|---------------------|---------------------------------|------------------------|
| Bonds payable | \$ 3,654,340 | \$ 267,460 | \$ (328,490) | \$ 3,593,310 | \$ 60,615 |
| Bond premiums and discounts | 177,554 | 33,209 | (20,094) | 190,669 | - |
| Total bonds payable | <u>3,831,894</u> | <u>300,669</u> | <u>(348,584)</u> | <u>3,783,979</u> | <u>60,615</u> |
| State loans | 146,672 | 22,343 | (9,962) | 159,053 | 11,133 |
| Compensated absences | 11,312 | 10,465 | (10,293) | 11,484 | 565 |
| Other post-employment benefits | 1,195 | 219 | (63) | 1,351 | - |
| Environmental remediation | <u>44,560</u> | <u>5,180</u> | <u>(4,940)</u> | <u>44,800</u> | <u>5,632</u> |
| Total long-term liabilities | <u>\$ 4,035,633</u> | <u>\$ 338,876</u> | <u>\$ (373,842)</u> | <u>\$ 4,000,667</u> | <u>\$ 77,945</u> |

| | Balance January 1, 2013 | Additions | Reductions | Balance December 31, 2013 | Due Within One Year |
|--------------------------------|-------------------------------|-------------------|--------------------|---------------------------------|------------------------|
| Bonds payable | \$ 3,662,370 | \$ 34,695 | \$ (42,725) | \$ 3,654,340 | \$ 57,630 |
| Bond premiums and discounts | 165,306 | 24,970 | (12,722) | 177,554 | - |
| Total bonds payable | <u>3,827,676</u> | <u>59,665</u> | <u>(55,447)</u> | <u>3,831,894</u> | <u>57,630</u> |
| State loans | 136,002 | 19,269 | (8,599) | 146,672 | 9,323 |
| Compensated absences | 11,249 | 9,985 | (9,922) | 11,312 | 572 |
| Other post-employment benefits | 1,040 | 219 | (64) | 1,195 | - |
| Environmental remediation | <u>35,201</u> | <u>13,952</u> | <u>(4,593)</u> | <u>44,560</u> | <u>5,715</u> |
| Total long-term liabilities | <u>\$ 4,011,168</u> | <u>\$ 103,090</u> | <u>\$ (78,625)</u> | <u>\$ 4,035,633</u> | <u>\$ 73,240</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 6 - Changes in Capital Assets

Changes in capital assets for the years ended December 31, 2014 and 2013 are shown in the following table (in thousands):

| | Balance January 1, 2014 | Increases | Decreases | Balance December 31, 2014 |
|---|-------------------------------|-------------------|---------------------|---------------------------------|
| Land | \$ 240,391 | \$ 2,602 | \$ - | \$ 242,993 |
| Easements | 11,469 | 251 | - | 11,720 |
| Construction work in progress | 316,142 | 141,595 | (174,952) | 282,785 |
| Total nondepreciable assets | <u>568,002</u> | <u>144,448</u> | <u>(174,952)</u> | <u>537,498</u> |
| Buildings | 1,829,718 | 42,268 | - | 1,871,986 |
| Improvements other than building | 65,593 | 1,728 | - | 67,321 |
| Artwork | 5,579 | 52 | (59) | 5,572 |
| Right of way | 7,635 | - | - | 7,635 |
| Infrastructure | 2,146,454 | 112,908 | - | 2,259,362 |
| Equipment | 1,047,837 | 24,772 | (33,826) | 1,038,783 |
| Software development | 33,308 | 2,295 | - | 35,603 |
| Total depreciable assets | <u>5,136,124</u> | <u>184,023</u> | <u>(33,885)</u> | <u>5,286,262</u> |
| Accumulated depreciation and amortization: | | | | |
| Building | (557,275) | (49,423) | - | (606,698) |
| Improvements other than building | (20,830) | (2,433) | - | (23,263) |
| Artwork | (512) | (156) | - | (668) |
| Right of way | (491) | (218) | - | (709) |
| Infrastructure | (437,331) | (46,066) | - | (483,397) |
| Equipment | (536,948) | (55,549) | 32,250 | (560,247) |
| Software development | (22,380) | (3,531) | - | (25,911) |
| Total depreciation and amortization | <u>(1,575,767)</u> | <u>(157,376)</u> | <u>32,250</u> | <u>(1,700,893)</u> |
| Depreciable assets - net | <u>3,560,357</u> | <u>26,647</u> | <u>(1,635)</u> | <u>3,585,369</u> |
| Total capital assets - net | <u>\$ 4,128,359</u> | <u>\$ 171,095</u> | <u>\$ (176,587)</u> | <u>\$ 4,122,867</u> |

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 6 - Changes in Capital Assets (Continued)

| | Balance January 1, 2013 | Increases | Decreases | Balance December 31, 2013 |
|---|-------------------------------|-------------------|---------------------|---------------------------------|
| Land | \$ 233,194 | \$ 7,197 | \$ - | \$ 240,391 |
| Easements | 11,469 | - | - | 11,469 |
| Construction work in progress | 291,826 | 149,371 | (125,055) | 316,142 |
| Total nondepreciable assets | <u>536,489</u> | <u>156,568</u> | <u>(125,055)</u> | <u>568,002</u> |
| Buildings | 1,808,253 | 22,101 | (636) | 1,829,718 |
| Improvements other than building | 64,690 | 903 | - | 65,593 |
| Artwork | 5,520 | 59 | - | 5,579 |
| Right of way | 7,635 | - | - | 7,635 |
| Infrastructure | 2,123,831 | 22,683 | (60) | 2,146,454 |
| Equipment | 985,447 | 65,031 | (2,641) | 1,047,837 |
| Software development | 33,239 | 69 | - | 33,308 |
| Total depreciable assets | <u>5,028,615</u> | <u>110,846</u> | <u>(3,337)</u> | <u>5,136,124</u> |
| Accumulated depreciation and amortization: | | | | |
| Building | (511,896) | (45,586) | 207 | (557,275) |
| Improvements other than building | (18,457) | (2,373) | - | (20,830) |
| Artwork | (334) | (178) | - | (512) |
| Right of way | (273) | (218) | - | (491) |
| Infrastructure | (391,112) | (46,219) | - | (437,331) |
| Equipment | (482,972) | (55,098) | 1,122 | (536,948) |
| Software development | (18,845) | (3,535) | - | (22,380) |
| Total depreciation and amortization | <u>(1,423,889)</u> | <u>(153,207)</u> | <u>1,329</u> | <u>(1,575,767)</u> |
| Depreciable assets - net | <u>3,604,726</u> | <u>(42,361)</u> | <u>(2,008)</u> | <u>3,560,357</u> |
| Total capital assets - net | <u>\$ 4,141,215</u> | <u>\$ 114,207</u> | <u>\$ (127,063)</u> | <u>\$ 4,128,359</u> |

Note 7 - Environmental Remediation

Water Quality operations are subject to rules and regulations enacted by the Washington State Department of Ecology (DOE) and the U.S. Environmental Protection Agency (EPA).

Water Quality follows GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations* (GASB 49), which mandates the disclosure of "obligations to address current or potential detrimental effects of existing pollution by participating in pollution remediation activities." GASB 49 establishes five events, any one of which obligates Water Quality to record a liability for pollution remediation expenditures. Liabilities are related to ongoing projects, which include the sediment management of aquatic habitats along Elliot Bay and the clean-up of certain sites along the Lower Duwamish Waterway (LDW). Environmental remediation costs that incurred prior to implementation of GASB 49 were capitalized and amortized over 40 years.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 7 - Environmental Remediation (Continued)

The Sediment Management Project has been approved by the Metropolitan King County Council as a self-obligated pollution remediation program. The LDW project became a Water Quality obligation when King County entered into an Administrative Order on Consent (AOC) with the DOE and EPA. This AOC also includes The Boeing Company, the City of Seattle and the Port of Seattle as parties conduct the studies on which to base the cleanup decision. Each party has agreed to pay one fourth of the costs under the AOC.

Both projects may result in additional cleanup efforts as a result of future regulatory orders. These potential cleanup liabilities cannot be currently estimated. Ongoing, regulatory action may identify other Potentially Responsible Parties (PRP) for the LDW cleanup.

There are no estimated recoveries at this time that will reduce the amount of Water Quality's pollution remediation obligations. The total environmental remediation liability at December 31, 2014 stands at \$44.8 million and \$44.6 million in 2013.

The pollution remediation obligation is an estimate and subject to changes resulting from price increases or reductions, technology, or changes in applicable laws or regulations.

The methodology for estimating liabilities continues to be based on Water Quality engineering analysis, program experience and cost estimates for the remediation activities scheduled to be undertaken in future years as programmed under Water Quality's Regional Wastewater Services Plan. Certain costs were developed by consulting engineers. Costs were estimated using the expected cash flow method set out by GASB 49. For the LDW project, a weighted average method is used to calculate the liability. The Sediment Management Plan does not employ weighted average cost estimation because the remaining work is well-defined and negates the utility of multiple estimates. The cost estimates continue to be re-measured as succeeding benchmarks are reached or when cost assumptions are modified. All pollution remediation obligations are being deferred as permitted by regulatory accounting standards (see Note 8 - Regulatory Assets and Credits).

Note 8 - Regulatory Assets and Credits

The King County Council has taken various regulatory actions resulting in differences between the recognition of revenues for rate-making purposes and their treatment under generally accepted accounting principles for nonregulated entities. Changes to these balances and their inclusion in rates may occur only at the direction of the Council.

Rate Stabilization - In 2005, the Council established a Rate Stabilization Reserve. This action created a deferred inflow of resource which deferred operating revenue to be set aside in a reserve and recognized in subsequent years to maintain stable sewer rates. The reserve was \$52.3 million in 2013 and decreased by \$18.0 million to \$34.3 million in 2014.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 8 - Regulatory Assets and Credits (Continued)

Pollution Remediation - In 2006, the Council approved the application of regulatory accounting to treat pollution remediation obligations as regulatory assets to allow for cost recovery through future rate increases. The portion of regulatory asset costs that have been accrued is being amortized over a recovery period of 30 years.

Rainwise Program - In 2013, the Council approved the application of regulatory accounting to treat program payments to Rainwise participants as regulatory assets to allow for cost recovery through future rate increases. The portion of regulatory asset costs that have been accrued is being amortized over a recovery period of 7 years.

Note 9 - Employee Benefit Plans

Defined Benefit Pension Plans - All full-time and qualifying part-time employees of Water Quality participate in the Public Employees' Retirement System (PERS). PERS is a statewide governmental retirement system administered by the State of Washington's Department of Retirement Systems.

The Department of Retirement Systems (DRS), a department within the primary government of the State of Washington, issues a publicly available Comprehensive Annual Financial Report (CAFR) that includes financial statements and required supplementary information for each plan. The DRS CAFR may be obtained by writing to: Department of Retirement Systems, Communications Unit, PO Box 48380, Olympia, WA 98504-8380; or it may be downloaded from the DRS website at www.drs.wa.gov.

Public Employees Retirement System - The Washington State Legislature established PERS in 1947. Membership in the system includes: elected officials; state employees; employees of the Supreme, Appeals, and Superior courts (other than judges currently in the Judicial Retirement System); employees of legislative committees; community and technical colleges, college and university employees not participating in higher education retirement programs; judges of district and municipal courts; and employees of local governments. PERS retirement benefit provisions are established in Chapters 41.34 and 41.40 RCW and may be amended only by the State Legislature.

PERS is a cost-sharing, multiple-employer retirement system comprised of three separate plans for membership purposes: Plans 1 and 2 are defined benefit plans and Plan 3 is a defined benefit plan with a defined contribution component. PERS members who joined the system by September 30, 1977, are Plan 1 members. Those who joined on or after October 1, 1977 and by either February 28, 2002, for state and higher education employees, or August 31, 2002, for local government employees, are Plan 2 members unless they exercise an option to transfer their membership to Plan 3. PERS participants joining the system on or after March 1, 2002, for state and higher education employees, or September 1, 2002, for local government employees, have the irrevocable option of choosing membership in either PERS Plan 2 or PERS Plan 3. The option must be exercised within 90 days of employment. Employees who fail to choose within 90 days default to PERS Plan 3.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 9 - Employee Benefit Plans (Continued)

PERS is comprised of and reported as three separate plans for accounting purposes: Plan 1, Plan 2/3, and Plan 3. Plan 1 accounts for the defined benefits of Plan 1 members. Plan 2/3 accounts for the defined benefits of Plan 2 members, and the defined benefit portion of benefits for Plan 3 members. Plan 3 accounts for the defined contribution portion of benefits for Plan 3 members. Although members can only be a member of either Plan 2 or Plan 3, the defined benefit portions of Plan 2 and Plan 3 are accounted for in the same pension trust fund. All assets of this Plan 2/3 may legally be used to pay the defined benefits of any of the Plan 2 or Plan 3 members or beneficiaries, as defined by the terms of the plan. Therefore, Plan 2/3 is considered to be a single plan for accounting purposes.

Employee contributions to the PERS Plan 1 and Plan 2 defined benefit plans accrue interest at a rate specified by the Director of DRS. Members in PERS Plan 1 and Plan 2 can elect to withdraw total employee defined benefit contributions and interest thereon, in lieu of any retirement benefit, upon separation from PERS-covered employment.

PERS Plan 1 members are vested after the completion of five years of eligible service. Plan 1 members are eligible for retirement from active status at any age with at least 30 years of service, at age 55 with 25 years of service, or at age 60 with at least 5 years of service. Plan 1 members retiring from inactive status prior to the age of 65 may receive actuarially reduced benefits. The monthly benefit is 2 percent of the average final compensation (AFC) per year of service, but the benefit may not exceed 60 percent of the AFC. The AFC is the monthly average of the 24 consecutive highest-paid service credit months. PERS Plan 1 retirement benefits are actuarially reduced to reflect the choice of a survivor benefit. Other benefits include disability payments, an optional cost-of-living adjustment, and a one-time duty related death benefit, if found eligible by the Department of Labor and Industries.

PERS Plan 2 members are vested after the completion of five years of eligible service. Plan 2 members are eligible for normal retirement at the age of 65 with five years of service. The monthly benefit is 2 percent of the AFC per year of service. The AFC is the monthly average of the 60 consecutive highest paid service months. There is no cap on years of service credit. PERS Plan 2 retirement benefits are actuarially reduced to reflect the choice of a survivor benefit.

PERS Plan 2 members who have at least 20 years of service credit and are 55 years of age or older are eligible for early retirement with a reduced benefit. The benefit is reduced by an early retirement factor (ERF) that varies according to age for each year before age 65.

If hired prior to May 1, 2013, PERS Plan 2 members who have 30 or more years of service credit and are at least 55 years old can retire early under one of two provisions: with a benefit that is reduced by 3 percent for each year before age 65; or with a benefit that has a smaller (or no) reduction (depending on age) that imposes stricter return-to-work rules. PERS Plan 2 members hired on or after May 1, 2013 have the option to retire early by accepting a reduction of 5 percent for each year of retirement before age 65. This option is available only to those who are age 55 or older and have at least 30 years of service.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 9 - Employee Benefit Plans (Continued)

PERS Plan 3 has a dual benefit structure. Employer contributions finance a defined benefit component and member contributions finance a defined contribution component. As established by Chapter 41.34 RCW, employee contribution rates to the defined contribution component range from 5 percent to 15 percent of salaries, based on member choice. Members who do not choose a contribution rate default to a 5 percent rate. Employers do not contribute to the defined contribution benefits.

PERS Plan 3 defined contribution retirement benefits are dependent upon employee contributions and investment earnings on those contributions. The defined benefit portion of PERS Plan 3 provides members a monthly benefit that is 1 percent of the AFC per year of service. The AFC is the monthly average of the 60 consecutive highest-paid service months. There is no cap on years of service credit. PERS Plan 3 benefits are actuarially reduced to reflect the choice of a survivor benefit.

Plan 3 members are immediately vested in the defined contribution portion of their plan. PERS Plan 3 members are vested in the defined benefit portion of their plan after ten years of service; or after five years of service if 12 months of that service are earned after age 44.

PERS Plan 3 members who have at least 10 years of service credit and are 55 years of age or older are eligible for early retirement with a reduced benefit. The benefit is reduced by an ERF that varies with age for each year before age 65. PERS Plan 3 members who have 30 or more years of service credit and are at least 55 years old can retire early by accepting the same reduction in benefits and conditions as those for PERS Plan 2 members.

PERS Plans 2 and 3 provide duty and non-duty disability payments, a cost-of-living allowance (based on the Consumer Price Index), capped at three percent annually, and a one-time duty-related death benefit, if found eligible by the Department of Labor and Industries.

PERS members meeting specific eligibility requirements have options available to enhance their retirement benefits. Some of these options are available to their survivors.

Each biennium, the state Pension Funding Council adopts PERS Plan 1 employer contribution rates, PERS Plan 2 employer and employee contribution rates, and PERS Plan 3 employer contribution rates. Contribution requirements are established and amended by state statute.

Water Quality's contribution rates expressed as a percentage of covered payrolls as of December 31, 2014 were as follows:

| | <u>PERS Plan 1</u> | <u>PERS Plan 2</u> | <u>PERS Plan 3</u> |
|----------|--------------------|--------------------|--------------------|
| Employer | 9.21% | 9.21% | 9.21% |
| Employee | 6.00% | 4.92% | 5.00%-15.00% |

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 9 - Employee Benefit Plans (Continued)

The employer rates include the employer administrative expense fee currently set at 0.18 percent. PERS Plan 3 is the defined benefit portion only. The employee rates for PERS Plan 3 may vary from 5 percent to 15 percent based on the rate selected by the PERS 3 member.

Water Quality's required employer contributions for the years ended December 31 was (in thousands):

| | PERS | |
|------|--------|---------------|
| | Plan 1 | Plans 2 and 3 |
| 2014 | \$ 88 | \$ 5,020 |
| 2013 | \$ 93 | \$ 4,353 |
| 2012 | \$ 98 | \$ 3,657 |

Note 10 - Other Post-Employment Benefits

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pension*, requires the County to accrue other post-employment benefits (OPEB) expenses related to its post-retirement healthcare plan based on a computed annual required contribution (ARC) that includes the current period's service cost and an amount to amortize unfunded accrued liabilities. The liability is included in noncurrent liabilities on the statements of net position for Water Quality.

Plan Description - The King County Health Plan (the Health Plan) is a single-employer defined benefit healthcare plan administered by the County. The Health Plan provides medical, prescription drug, vision, and other unreimbursed medical benefits to eligible employees. The Health Plan's actuary is Healthcare Actuaries and it does not issue a separate stand-alone financial report.

Funding Policy - Law Enforcement Officers' and Fire Fighters' Retirement System Plan (LEOFF) 1 retirees are not required to contribute to the Health Plan. All other retirees are required to pay the COBRA rate associated with the elected plan. Water Quality contributed an estimated \$63 thousand and \$64 thousand to the Health Plan during both 2014 and 2013, respectively. The contribution was entirely to fund "pay-as-you-go" costs under the Health Plan and not to advance fund the cost of benefits.

Annual OPEB and Net OPEB Obligation - The basis of the County's annual OPEB cost (expense) is the ARC. The ARC represents a level of funding that, if paid on an ongoing basis, the actuary projects will cover normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

KING COUNTY WATER QUALITY ENTERPRISE FUND
NOTES TO FINANCIAL STATEMENTS

Note 10 - Other Post-Employment Benefits (Continued)

Water Quality's allocated annual OPEB costs, the percentage of annual OPEB cost contributed to the Health Plan, and the net OPEB obligation for the years ended December 31, 2014 and 2013 were as follows (in thousands):

| | 2014 | 2013 |
|---|-----------------|-----------------|
| Normal cost - Unit Credit Method | \$ 193 | \$ 193 |
| Amortization of unfunded actuarial accrued liability (UAAL) | 32 | 32 |
| Annual Required Contribution (ARC) | 225 | 225 |
| Interest on net OPEB obligation | 4 | 4 |
| Adjustment to annual required contribution | (10) | (10) |
| Annual OPEB cost (expense) | 219 | 219 |
| Contributions made | (63) | (64) |
| Increase in net OPEB obligation | 156 | 155 |
| Net OPEB obligation - beginning of year | 1,195 | 1,040 |
| Net OPEB obligation - end of year | <u>\$ 1,351</u> | <u>\$ 1,195</u> |

Water Quality's allocated annual OPEB costs, the percentage of annual OPEB costs contributed to the Health Plan, and the net OPEB obligation were as follows (in thousands):

| Year Ended | Annual OPEB Cost | Percentage of Annual OPEB Cost Contributed | Net OPEB Obligation |
|------------|---------------------|---|------------------------|
| 12/31/2014 | \$ 219 | 29.0% | \$ 1,351 |
| 12/31/2013 | \$ 219 | 29.2% | \$ 1,195 |
| 12/31/2012 | \$ 246 | 25.2% | \$ 1,040 |

Required Supplementary Information: Funded Status and Funding Progress - The funded status of the Health Plan as of December 31, 2014 and 2013 was as follows (in thousands):

| | 2014 | 2013 | 2012 |
|--|-------------------|-------------------|-------------------|
| Actuarial Value of Plan Assets | \$ - | \$ - | \$ - |
| Actuarial Accrued Liability (AAL) | 167,420 | 167,420 | 178,502 |
| Unfunded Actuarial Accrued Liability (UAAL) | <u>\$ 167,420</u> | <u>\$ 167,420</u> | <u>\$ 178,502</u> |
| Funded Ratio (actuarial value assets/AAL) | 0% | 0% | 0% |
| Covered Payroll (active plan members) | \$ 1,073,511 | \$ 1,000,353 | \$ 961,982 |
| UAAL as a percentage of covered payroll (AAL less actuarial value of assets/UAAL) | 15.6% | 16.7% | 18.6% |

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 10 - Other Post-Employment Benefits (Continued)

Actuarial Methods and Assumptions - The basis of projections of benefits for financial reporting purposes is the substantive plan (the Health Plan as understood by the County and members of the Health Plan) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the County and Members of the Health Plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

The December 31, 2013 valuation used the projected unit credit actuarial cost method. The actuarial assumption included a 2.29 percent investment rate of return (net of administrative expenses) and an initial healthcare cost trend rate of 8.0 percent for KingCare medical, 7.0 percent for KingCare pharmacy, and 8.0 percent for HMO medical/pharmacy, each reduced by decrements to an ultimate rate of 4.2 percent after 70 years and 7 years for medical and pharmacy, respectively. The miscellaneous trend rate is 7.0 percent, and the Medicare premium trend rate is 6.0 percent, for all years. All trend rates include a 3.0 percent inflation assumption. The amortization of the UAAL at transition uses a level dollar amount on an open basis. The UAAL is recalculated each year and amortized as a level dollar amount on an open basis over 24 years.

Note 11 - Interfund Balances and Transfers

Water Quality is an enterprise fund of the County and reports in its financial statements interfund balances and transfers as a result of intracounty activity with other County agencies.

Interfund Balances - The balances result from the time lag between the dates when interfund goods and services were provided or reimbursable expenditures incurred and when interfund payments were made, Water Quality reported total due from other funds of \$1.2 million at December 31, 2014. Water Quality had total due from other funds of \$4.0 million and due to other funds of \$5 thousand, respectively, at December 31, 2013.

Interfund Transfers - The King County Council approves ordinances and/or motions authorizing Water Quality to contribute and receive amounts to and from various County funds. During 2014 and 2013, the transfers from Water Quality to other funds were \$173 thousand and \$70 thousand, respectively.

Note 12 - Commitments and Contingencies

Construction and Maintenance Programs - To ensure the continued operation, reliability, and compliance with regulatory standards of existing wastewater treatment facilities, Water Quality is committed to expending approximately \$115.1 million on active construction contracts as of December 31, 2014.

KING COUNTY WATER QUALITY ENTERPRISE FUND NOTES TO FINANCIAL STATEMENTS

Note 12 - Commitments and Contingencies (Continued)

Contingencies and Claims - There is no litigation or claim currently pending against the King County Water Quality Enterprise Fund in which, to management's knowledge, the likelihood of an unfavorable outcome with material damages assessed against the enterprise is considered "probable."

The following litigation, or potential litigation, may involve claims for material damages against the King County Water Quality Enterprise Fund for which Water Quality is unable to provide an opinion as to the ultimate outcome or the amount of damages that may be found:

- An administrative order from the EPA that requires the County, the City of Seattle, the Boeing Company, and the Port of Seattle to conduct a feasibility study to determine the nature and extent of the contamination in the Lower Duwamish Waterway. The feasibility study has been issued in final form by EPA. EPA issued a Record of Decision in the later part of 2014. Due to the high level of legal and regulatory review for the County and other parties with the intention of entering into a settlement agreement and negotiating a consent decree with EPA, the County is unable to determine the schedule and cost of any required remediation or the extent of County responsibility.
- A potential requirement for more cleanup in the area contaminated when the Denny Way combined sewer outflow was replaced in 2005. The King County Wastewater Treatment Division (WTD) has already performed interim cleanup costing \$3.6 million to comply with a formal agreement with the Washington State Department of Ecology, who reserves its rights to require additional remediation.
- Potential claims for past and future cleanup costs at the Harbor Island Superfund Site. Certain removal costs already incurred by the Port of Seattle are expected to be defrayed by the County and the City of Seattle. The parties have also agreed to share the cost of a supplemental investigation and feasibility study required by the U.S. Environmental Protection Agency. The agreement states that WTD has only a one-third pro rata share of the study costs and that portion is still potentially allocable among the several potentially responsible parties. Further remediation costs cannot be reasonably estimated until the study is completed.
- A series of requests for change orders and claims for damages from the prime contractor for the Brightwater Treatment Plant central conveyance system alleging differing site conditions and defective specifications. The County vigorously defended against the claims and filed suit alleging contract default by the contractor for failure to complete the contract work within time limits. The County received a jury verdict of \$155 million on December 21, 2012. The contractor received a verdict of \$26.2 million. Rulings on post-trial motions were issued on April 19, 2013, leaving in place the verdict amounts. The rulings also awarded the County additional \$14.7 million for its legal costs. The contractor has paid the net judgment amount and filed the appeal. The cash received is set aside and a liability recorded by Water Quality until the appeal is completed.

KING COUNTY WATER QUALITY ENTERPRISE FUND

NOTES TO FINANCIAL STATEMENTS

Note 13 - Subsequent Event

In February 2015, Water Quality issued \$474.0 million of sewer revenue refunding bonds, 2015, series A, and \$247.8 million of limited tax general obligation (payable from sewer) refunding bonds, 2015, series A. The bonds bear interest at stated rates of 2.0 percent to 5.0 percent per annum. The proceeds from these bonds were used to refund all of the sewer revenue bonds, series 2007; a portion of sewer revenue bonds, series 2008 and series 2009; and a portion of the outstanding Limited Tax General Obligation Bonds (payable from sewer revenues), 2009.

**KING COUNTY WATER QUALITY ENTERPRISE FUND
SUPPLEMENTAL INFORMATION
SUPPLEMENTAL SCHEDULE OF NET REVENUES AVAILABLE FOR
DEBT SERVICE (UNAUDITED)
YEAR ENDED DECEMBER 31, 2014**

Water Quality is obligated by applicable bond ordinances to set sewage disposal rates at a level adequate to provide net revenue equal to at least 1.15 times the annual debt service requirements for sewer revenue and general obligation bonds payable from revenues of Water Quality. It is an adopted policy of Water Quality to achieve a debt service coverage ratio of 1.25.

Coverage (1.15 required by covenant, adopted policy 1.25) 1.44

In 2001, Water Quality adopted a new debt service target of 1.15 times the annual debt service for bonds, obligations, notes, and loans of Water Quality.

Coverage (1.15 adopted target) 1.33

Water Quality is required to generate revenues sufficient to pay all costs of operation of the sewage treatment system and debt service on obligations of Water Quality.

Coverage (1.00 required by covenant) 1.26

In 2001, Water Quality issued an additional tier of revenue bonds. The bond covenants of the Junior Lien Variable Rate Demand Sewer Revenue Bonds, Series 2001A and Series 2001B, require that sewage disposal rates provide net revenue equal to at least 1.10 times the annual debt service requirements for all Junior Lien obligations after payment of senior lien requirements. In 2010, Water Quality issued Multi-Modal Limited Tax General Obligation Sewer Revenue Bonds, series 2010A and 2010B which incorporate the identical requirement as Junior Lien obligations. In 2011 and 2012, Water Quality issued \$100M of Junior Lien Variable Rate Demand Sewer Revenue Bonds which incorporate the identical requirement as Junior Lien obligations.

Coverage (1.10 required by covenant) 31.95